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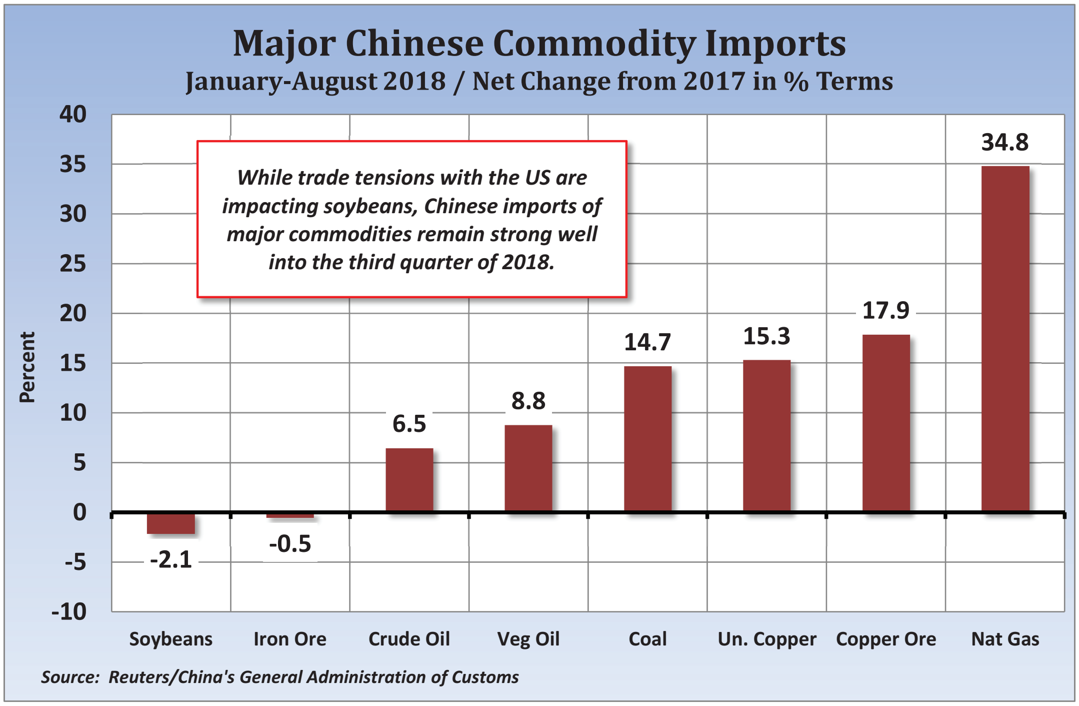
Inflation - No Longer a Longshot



Given that the last significant inflation period was decades ago, it is not surprising that the marketplace has become convinced that a return to inflationary conditions is extremely unlikely. In the wake of the subprime debacle, many economists suggested that a return of inflation would be decades in the making. But looking at current events, it would appear that a classic prescription for such a return has already been written and that it is coming to fruition quicker than many would have expected.

Cheap goods and cheap labor from China have been the primary deflationary impetus over the last 15 years, but the recent series of events suggests that China could become the inflationary spark in the future. China continues to consume ravenous amounts of commodities as it modernizes and pushes toward an economy more reliant on domestic consumption. Business as usual on trade relations no longer seem acceptable by China's largest trading partner, the United States. Consequently, both countries have launched into a cycle of tariffs that will not only raise costs to US and Chinese consumers but will also result in international prices rising to match the tariff-adjusted levels of Chinese and US goods. Increased raw material prices should lead to higher wholesale prices, higher retail prices, and should eventually put upward pressure on wages.

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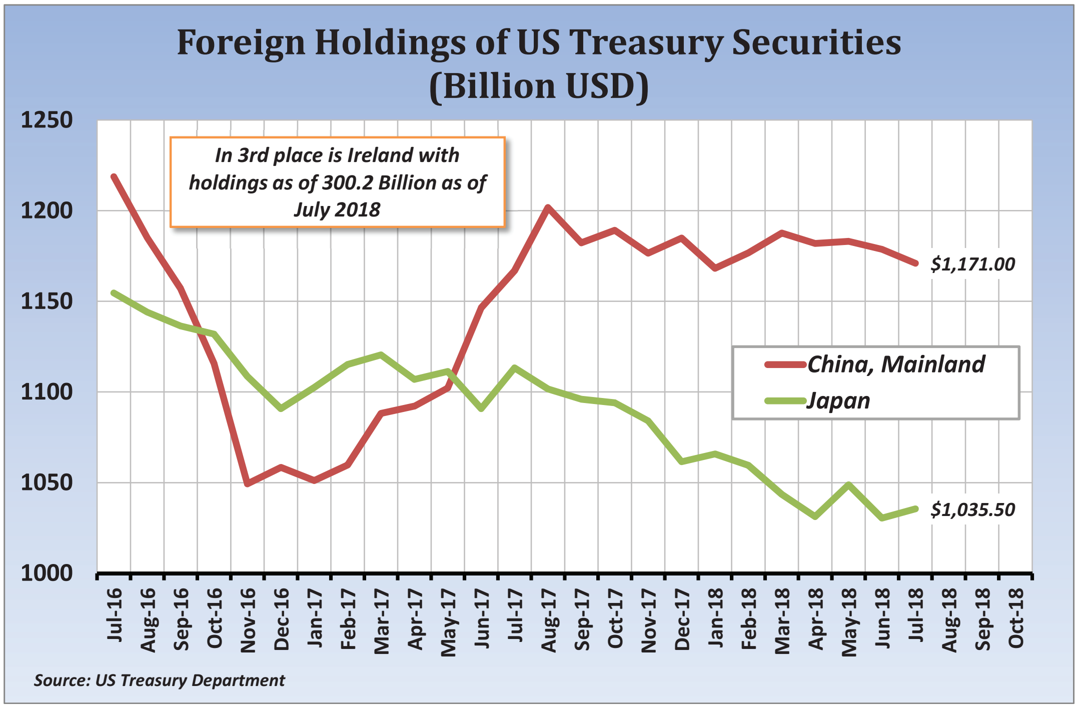
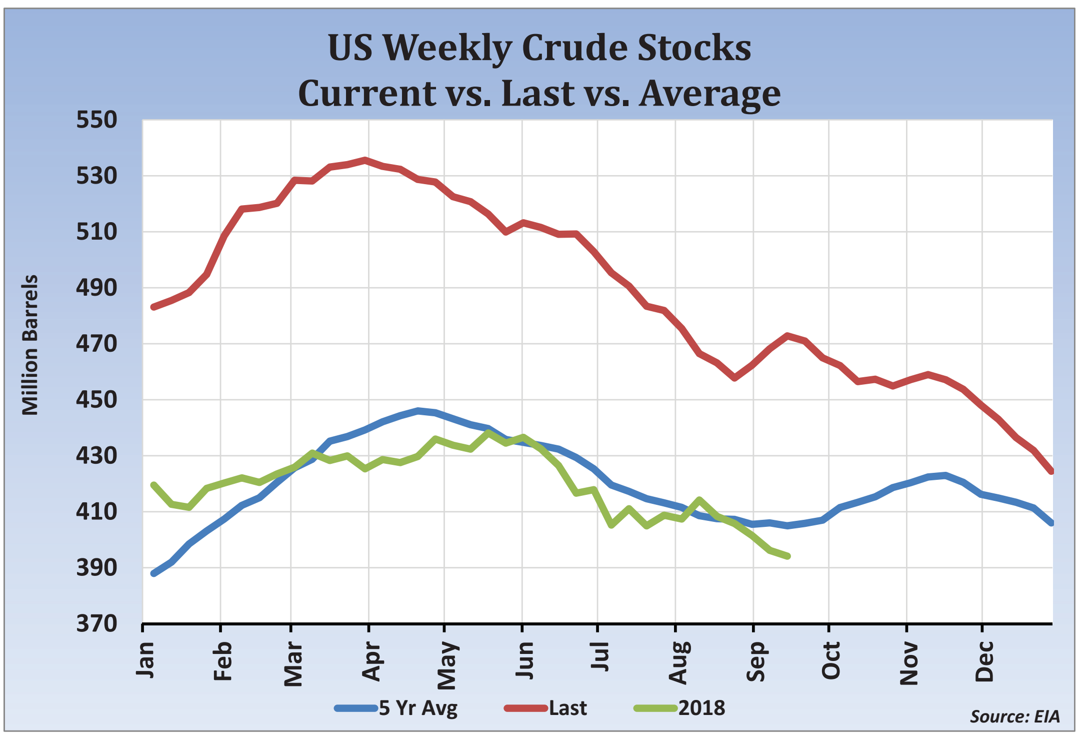
Furthermore, China has recognized the potential threat to their economy from the cycle of tariffs and is moving aggressively to expand infrastructure activity, which should add to wage pressures and to physical commodity demand. However, China's ability to contain inflation has moved beyond its borders and has become difficult for them to control.



Another issue that could contribute to the inflation environment is recent evidence that key foreign investors of US Treasuries are beginning to reduce their purchases. This has pushed certain US mortgage rates up to their highest levels in several years. The importance of foreign investment to the US Treasury market is magnified by the fact that US debt continues to expand. Evidence of the rotation away from US Treasury holdings was seen last month, when Japanese holdings of US Bonds fell to their lowest levels since October 2011. Even a slight removal of foreign buying in the face of expanding supply should mean US Treasury yields will have to increase that much further to attract buyers.



The record US debt is mirrored around the world, as many nations loosened money and borrowed heavily to survive the subprime crisis and have yet to work it off. A slight rise in US yields would likely result in wave of higher yields in non-US debt as well, as governments and central banks are forced to compete.

While the energy space isn't a glaring inflationary force yet, it should be noted that US oil production continues to post new all-time highs at the same time that US crude stocks in the US have maintained a sizable, 78.6 million-barrel deficit relative to year-ago levels. Record US production is being swallowed up by domestic demand and by expanding exports. US and China refinery throughput levels continue to operate at record levels, which suggests the demand for gasoline and other petroleum products remains high. Demand for energy worldwide is such that extremely low prices in corn and soybean oil are ramping up biofuel production. This may soon provide a floor to grain prices.

The classic definition of inflation is "money chasing money," and the cycle of tariffs, rising energy prices, rising developing-world wages, and rising interest rates sets the stage for the start of something.

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